

Hungary



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Investment Profile 2001



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EBRD ANNUAL MEETING



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Introduction

Hungary is an outstanding success story of political and economic transition in central and eastern Europe. The country has implemented the most comprehensive market-based privatisation and restructuring programme in the region. Macroeconomic policies have been prudent. This has attracted the highest per capita foreign direct and portfolio investment levels. As a result, the country has a dynamic economy, an internationally oriented industrial sector and the strongest banking sector in the region. Hungary is also a stable democracy with high international prestige. In 1999 it became a full member of NATO. The country is a front runner for EU accession.

Political and economic transition

Consecutive governments since 1990 have pursued an economic and political programme aiming to build up an open and liberalised market economy, and a political system based on democratic values. The first freely elected government, led by the centre-right Hungarian Democratic Forum, launched the first reform programme liberalising foreign trade, freeing prices, reducing subsidies and improving the position of the private sector. The reforms had painful short-term effects as output contracted and unemployment increased. Hungary also faced problems resulting from high government expenditure and a high current account deficit. To cure these problems, in March 1995, a radical austerity programme was introduced by the next government, led by the Hungarian Socialist Party. After initial adjustment problems, these policies brought very positive results by 1997, when GDP grew by 4.6 per cent. The budget and the current account deficits were reduced as well.

Since May 1998, the country has been governed by a coalition of the centre-right Fidesz-Hungarian Civic Party and the conservative-agrarian Smallholders Party, along with the Democratic Forum. The government has been conducting a prudent economic policy and has presided over the further stabilisation of the economic climate. It has also put more emphasis on encouraging Hungarian small and medium-sized enterprises (SMEs), increasing family benefits and spreading prosperity to less developed rural areas.

The current government has issued the **Szechenyi Plan**, Hungary's national economic development plan that lists the priorities for government policies and establishes the direction for medium-term economic development. The Plan includes programmes for enterprise, tourism, housing, research, information society, infrastructure and regional development. Its full text is available on the web site of the Hungarian Ministry of Economic Affairs: www.gm.hu

Challenges met and challenges ahead

Hungary is one of the most successful transition countries. In the last 10 years, it has created a stable and well-functioning multi-party democracy and a prosperous market economy with strong foundations. Around 80 per cent of the economy is privatised – a higher percentage than in many EU states. Hungary has attracted more than US\$ 20 billion in foreign direct investment – more per capita than any other central and eastern European country. (See *Investment climate* below.) The country also has one of the most stable and mature financial markets, with the banking sector predominantly in foreign hands. (See *Financial sector* below.) In the last four years, the economy has been on an impressive growth path, expanding at around 5 per cent each year, while the fiscal and current account balances have remained stable. (See *Economic summary* below.) Important new developments in the enterprise sector in 2000 included the regional expansion of some of the largest and most successful Hungarian companies, and an increasing number of mergers and acquisitions with a strong consolidation effect on certain sectors. The country is also preparing for the liberalisation of its service sector (telecommunications and energy), which will create new opportunities for growth and investment.

However, alongside the successes, the country still has some challenging issues to resolve. Among them, on the macroeconomic side, the most urgent tasks are to deliver the reform of the public finances, especially concerning the health care system and the performance of local governments, and to achieve further progress towards increased price stability. The country also needs progress on fighting the grey economy in order to enhance the sustainability of its public finances. A further important issue is the growing regional divide between Budapest and western Hungary on the one hand, and the east of the country on the other, which the current government has been trying to address by offering incentives for investors in economically depressed regions and increased funding for rural areas. Finally, in preparation for EU accession, the country has to invest heavily into bringing Hungary closer to EU environmental standards.

International relations and regional co-operation

The key objective of Hungarian foreign policy is to accomplish membership in the EU, for which the country is a front runner among the central and eastern European countries. Accession talks with the EU started in 1998 and have progressed well so far. Hungary has received consistently high marks in the Commission's Regular Reports, and the government is determined to complete its preparation for membership by the end of 2002. (See *EU integration* for details below.) In March 1999, Hungary became a member of the North Atlantic Treaty Organisation (NATO), an achievement that reflects the country's high international standing.

Hungary also strives to conduct a policy of good neighbourly relations. The country has signed basic treaties with most of its neighbours that have contributed positively to the improvement of political, economic and cultural relations. Policies aimed at helping Hungarian communities living outside Hungary to preserve their national identity and traditions and to assert their minority rights are one of the priorities of the Hungarian government, and important progress has been made in this area in recent years. Regional economic and trade integration is advancing within the framework of the Central European Free Trade Agreement (CEFTA). CEFTA was formed by Hungary, Poland and Czechoslovakia in 1991, with Bulgaria, Romania and Slovenia joining subsequently.

EU integration progress

Following the signing of the association agreement in 1991 and the application for membership in 1994, Hungary opened accession negotiations in March 1998. As a result of these negotiations, 13 chapters out of the 31 were provisionally closed, while negotiations continue for the remaining chapters. The Hungarian government pledged to achieve full harmonisation with and implementation and enforcement of the *acquis* by the end of 2002 and is well on target.

Since January 2000, three pre-accession instruments financed by the European Community have been made available to assist Hungary, as well as other applicant countries, in their pre-accession preparations: the PHARE programme; SAPARD, which provides aid for agricultural and rural development (see *Major Sectors of the economy* below); and ISPA, which finances infrastructure projects in the fields of environment and transport. In the years 2000-02 total financial assistance to Hungary will amount annually to € 96 million from PHARE, € 38.7 million from SAPARD, and € 87.7 million from ISPA.

The largest amount of PHARE funding went to projects aiming to reinforce institutional and administrative capacity in taxation, customs, agriculture and environment, as well as to projects serving as pilot regional programmes for the preparation of Structural Fund implementation.

In November 2000, the EU published its regular report on Hungary's progress towards accession. The main issues identified by the document are as follows:

Progress:

- Should be able to cope with competitive pressure and market forces within the EU in the near term.
- Considerable progress towards consolidating macroeconomic stability and enhancing current account sustainability.
- Progress in aligning and implementing the EU law in most sectors.
- High economic growth.
- Narrowing fiscal deficit.
- Improved competitiveness.
- Good export performance.
- Progress in the modernisation of the public administration.

Progress yet to be made:

- Fulfilment of EU environmental standards needs to be speeded up.
- Funding for underdeveloped regions should be increased.
- Dialogue with trade unions should be reinforced.
- Progress towards price stability should be strengthened.
- Need for financial consolidation (particularly in the areas of health care and transportation).
- Financial sector supervision needs to be improved.
- Programme to assist the social and economic integration of the Roma minority and to combat discrimination against them should be reinforced.
- Government intervention in the media should be curtailed.
- Need to reinforce recent efforts on fighting corruption.



For the full text of the latest EU Progress Report on Hungary and other enlargement related information see:

www.europa.eu.int/comm/enlargement/hungary/index.htm

Information on the PHARE programme is available on the EU Commission's web site and the Hungarian government's PHARE web site:

www.europa.eu.int/comm/enlargement/pas/phare/index.htm;

www.meh.hu/pharekoord/home/

Economic summary



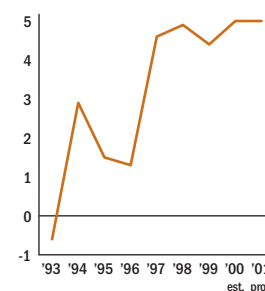
In 2000, Hungary continued to maintain an outstandingly good economic climate: the economy grew at a rate of 5 per cent, employment continued growing for the third year in a row, the unemployment rate was one of the lowest in the region, and the fiscal and current account deficits remained contracted. The impressive economic performance is largely export driven. In 2001, the economy is expected to continue to grow at a rate of close to 5 per cent, as a forecasted drop in exports, due to the slowdown of the EU economies, will be compensated by increased domestic demand. The positive economic trends in 2000 further strengthened the country's position among the leading candidates for accession to the EU.

GDP growth

GDP growth was robust in 2000, peaking at 6.6 per cent year on year in the first quarter of 2000, although a marked slowdown of the economy was observed in the second half of the year. Full year growth for 2000 amounted to an estimated 5 per cent. Growth in 2000 was underpinned by a sharply accelerating trend in industrial production and massive export growth targeting EU markets.

The impressive GDP growth is forecast to continue in 2001. Demand in Hungary's main export markets remained stable in the second half of 2000, indicating the continuation of export-driven growth in 2001, while forecasted domestic demand will not exceed the GDP growth rate in 2001.

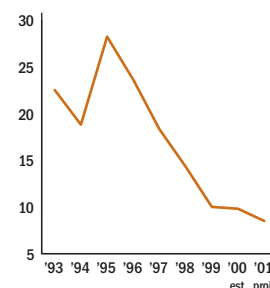
GDP
% change



Inflation

Hungary managed to achieve only limited progress on disinflation, as annual average consumer prices, which have been on a steady downward path in the last few years, dropped only by 0.3 per cent as compared to 1999. The inflationary pressure was largely caused by food and oil price rises during the summer months, but core inflation increased slightly in the last four months of the year, partly driven by domestic demand. Falling oil prices, the strengthening of the euro and tightened monetary policy, are likely to support some disinflation in 2001. On the other hand, scheduled increases in utility prices and a 57 per cent increase in minimum wages are likely to put further pressure on consumer prices.

Consumer prices
Annual average, % change

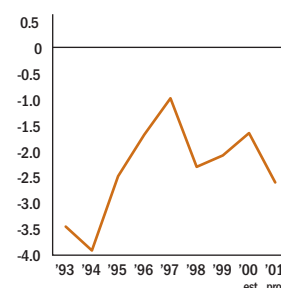


Current account

A massive acceleration in export growth, peaking at around 36 per cent year-on-year in euro terms in September 2000, alongside more moderate import growth, helped the rolling 12-month current account to fall to an estimated 3.9 per cent of GDP in December 2000, down from 4.3 per cent at the end of 1999. The strong export performance was driven by growth in the EU markets as 80 per cent of merchandise exports targeted EU countries in 2000. The repatriation of profits from foreign-owned companies operating in Hungary remained stable and more evenly distributed during the year than in the past (with no peak in repatriation at the end of the year). High FDI inflows helped greatly to cover the current account deficit.

In 2001, export costs are expected to fall as oil prices ease from current highs. As growth in the EU countries is expected to lose pace, export volume growth is forecast to slow, but is still likely to remain in double digits.

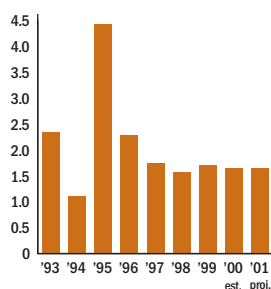
Current account
US\$ millions



Source: Hungarian Ministry of Finance, January 2001

Total FDI

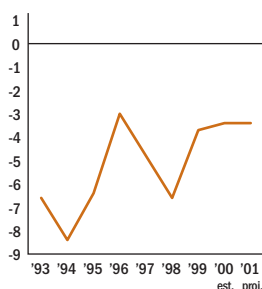
US\$ billions, cash receipts, net*



* Holding company loans (or intercompany loans) included

General government balance

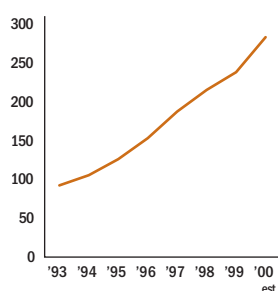
% of GDP *



* GFS excluding privatisation receipts

Exchange rate

Annual average, forints per US\$



Source: Hungarian Ministry of Finance, January 2001

FDI and privatisation

Despite the phasing out of most foreign investment incentives, a stable and favourable business environment and a large skilled work force continued to attract a robust flow of FDI, increasingly into capital and skill-intensive sectors. Net FDI inflows amounted to € 2.1 billion in 2000 and a similar performance is expected in 2001. In recent years, most of the inflows have represented greenfield investment, as the privatisation process has neared completion, and only a very few large enterprises are left for sale.

Government balance

The general government deficit reached 3.4 per cent of GDP in 2000, according to preliminary figures, down from 3.7 per cent in the previous year. High revenues, made up of robust tax payments as a result of high economic growth, greatly contributed to the favourable trend in the fiscal deficit.

The two-year budget passed by Parliament in December 2000 aims to reduce the public sector deficit to around 3 per cent of GDP in 2001-02. This is the country's first two-year budget, introduced with the aim of increasing the predictability of the macroeconomic environment. Meeting inflation targets will be a crucial factor in deciding on the feasibility of the budget. In the coming years, expenditure will be under pressure from increased spending on NATO and EU commitments and overruns on the social security funds. Hungary has to implement far-going structural reforms in government spending, particularly relating to the healthcare fund, in order to secure sustainable development of its public finances in the medium term and to bring the fiscal system up to date, including institution building, expenditure management and treasury operations.

Exchange rates

The Hungarian forint (HUF) is pegged solely to the euro and the crawling peg is set at 0.3 per cent per month, with a fluctuation band of +/- 2.25 per cent from January 2001. Reflecting the high degree of integration with the EU, the currency composition of the basket to which the currency is pegged was changed in January 2000 to comprise the euro only. In April 2000, as a consequence of the deterioration in inflation data, plans to cut the rate of the crawl were abandoned. A small cut, from 0.3 per cent to 0.2 per cent, is scheduled to take place in April 2001. It is also expected that, if inflation continues its downward trend, the fluctuation band will be gradually widened towards the end of 2001 and the crawling peg will be dismantled, most likely in 2002.

EU convergence issues

The latest annual EU Progress Report confirmed Hungary's place among the leading candidates for EU accession. The EU praised the country's economic performance, especially progress made towards consolidating macroeconomic stability, enhancing current account sustainability and strengthening the institutional basis of the market economy. The EU also took the view that Hungary has a fully functioning market economy and should be able to cope with the competitive

pressures and market forces within the Union “in the near term, provided it stays with its present reform path”. At the same time, the report singled out disinflation and the reform of public finances, especially relating to healthcare and transport, as areas where further efforts are needed. (See *EU integration* above for details.)

Credit ratings

Standard & Poor's sovereign ratings, January 2001

Local Currency			Foreign currency		
Long-term	Outlook	Short-term	Long-term	Outlook	Short-term
A+	Stable	A-1	A-	Stable	A-2

Moody's country ceilings for foreign currency ratings, January 2001

Bonds and notes		Bank deposits	
Long-term	Short-term	Long-term	Short-term
A3	P-2	A3	P-2

Fitch IBCA foreign currency sovereign ratings, January 2001

Long term	Short term
A-	F2

Selected economic indicators

	1993	1994	1995	1996	1997	1998	1999	2000 est.	2001 proj.
GDP (% change)	-0.6	2.9	1.5	1.3	4.6	4.9	4.4	5.0	5.0
Consumer prices (annual average % change)	22.5	18.8	28.2	23.6	18.3	14.3	10.0	9.8	8.5
Current account (in US\$ billions)	-3.45	-3.91	-2.48	-1.68	-0.98	-2.30	-2.08	-1.65	-2.60
General government balance (% of GDP)*	-6.6	-8.4	-6.4	-3.0	-4.8	-6.6**	-3.7	-3.4	-3.4
Trade balance (in US\$ billions)	-3.25	-3.64	-2.44	-2.65	-1.96	-2.35	-2.18	-2.17	-4.32
Total FDI (in US\$ billions, cash receipts, net)***	2.33	1.10	4.41	2.28	1.74	1.56	1.7	1.65	1.65
External debt stock (US\$ billions)***	24.57	28.53	31.66	27.96	24.4	27.28	29.28	32.22	na
Unemployment (% of labour force)	11.9	10.7	10.2	9.9	8.7	7.8	7.0	na	na
Exchange rate, annual average, forints per US\$	92.0	105.1	125.7	152.6	186.8	214.5	237.3	282.2	na
Gross reserves, excluding gold (end-year, US\$ billions)	6.69	6.73	11.97	9.68	8.40	9.31	10.95	11.00	na

* GFS balance of general government excluding privatisation receipts (in GDP percentage)

** -4.8 per cent excluding special expenses (Postabank stabilisation)

*** Holding company loans (or intercompany loans) included

Source: Hungarian Ministry of Finance, January 2001



Investment climate

Hungary has been one of central and eastern Europe's most attractive destinations for foreign investors in the last decade. The country's success lies mainly in its successful economic transition and in the fact that successive governments have shown a greater readiness to privatise and accommodate the need of foreign investors than most others in the region. This trend is due to continue, helped by the good growth records of recent years, the prospect of EU membership and planned further liberalisation, e.g. in the telecom and energy sectors. As privatisation neared completion in 2000, FDI has been increasingly based on greenfield investments. The government is also trying to engineer the process by offering special incentives for investments in less developed regions, developing industrial parks and through a subcontracting programme for SMEs.

Foreign direct investment

In the last decade, over US\$ 23 billion in foreign direct investment (FDI) has entered Hungary. The country received almost one-third of all FDI invested in central and eastern Europe during this period. From the mid-1990s onwards, the FDI inflow has slowed down as major privatisation deals have been completed, but in 2000 it again increased sharply. In 2000, gross FDI inflows amounted to US\$ 1.957 billion.

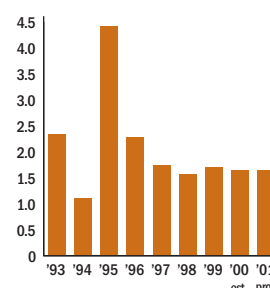
The importance of foreign investors to the economy is reflected in the fact that foreign-owned companies, mainly multinational firms, generate 77 per cent of Hungary's exports, some 33 per cent of its GDP and 25 per cent of private sector employment. More than 18,000 joint ventures are registered in Hungary and 35 of the world's 50 largest multinational companies have a Hungarian subsidiary.

Much of the early investment was the result of the strategic privatisation of state-owned enterprises. However, in recent years more and more FDI has been in the form of greenfield investments. Hungary's primary strengths for investors are its favourable policies towards foreign investors and special tax

incentives (which were in place until 1995), its transparent and commercially viable method of privatisation, its high economic growth, well-developed financial and commercial infrastructure, well-educated labour pool, and its geographic location. A large number of foreign companies see Hungary as a natural springboard for the region, as a total of 80 multinational companies have their regional headquarters in the country.

Almost two thirds of the foreign investment in Hungary comes from the EU, while the US, the single largest investor, has been responsible for around 35 per cent of all FDI. In the first half of 2000, the major investors were the Netherlands (32 per cent), Germany (17 per cent), the US (14 per cent) and the UK (11 per cent). Increasing Dutch investment has been a relatively new development.

Total FDI
US\$ billions, cash receipts, net*



* Holding company loans (or intercompany loans) included

Source: Hungarian Ministry of Finance, January 2001

Top 10 foreign investors, as at December 2000

Company	Country of origin	Investment, US\$ million	Sector
Magyarcom/ Ameritech International/Deutsche Telekom	US/Germany	1,700	Telecommunications
GE Lighting	US	776	Light source production
RWE Energie/Energie Baden Wurttemberg	Germany	720	Electricity generation and distribution
Audi	Germany	600	Automotive
KPN/Telenor Invest/Tele-Danmark/Sonera	Netherlands/Norway/Denmark/Finland	500	Telecommunications
General Motors	US	440	Automotive
Bayernwerk	Germany	430	Electricity distribution and generation, gas distribution
Banca Commercial Italiana Group	Italy	381	Banking services
Coca-Cola Beverages Ltd.	US	300	Food industry

Source: Budapest Business Journal

Concerning future investment prospects, further liberalisation in the energy, telecommunications and health care sectors and also EU membership are expected to attract investors in high numbers. A strong pace of investment is expected in the information technology (IT), tourism, automotive, electronics, and research and development sectors.

Privatisation

The privatisation process is nearing completion as almost 80 per cent of the economy has been privatised and only a very few large assets are left in state hands. The State Privatisation and Holding Agency (APV Rt.) manages and sells state owned properties. Between 1995 and 1997 large strategic companies (public utility service providers, banks, companies of strategic importance) were privatised at an accelerated pace mainly to strategic investors. In 2000, only a few relatively small privatisation deals were completed, among them sales of the K&H Bank Rt. (minority stakes), Nitrokemia (chemicals), and ITC (real estate management). Some of the major transactions have been postponed, such as the planned sale of share packages in Hungaropharma (pharmaceuticals), Antenna Hungaria (broadcasting) and steel maker Dunaferr. One of the most eagerly anticipated deals, the tender launched in late 2000 to sell a minority stake in the national air carrier MALEV, did not attract any bids. APV Rt. attributed the failure of the privatisation to the unfavourable situation on the international airline market, the company's losses due to rising fuel costs, and intensive competition and the oversupply of airline companies waiting to be privatised. (See *Major sectors of the economy* below.)

Remaining state ownership in the banking system is also low, while the presence of foreign investors is very high. Foreign banks hold controlling stakes in 27 banks, and total foreign ownership is around 60 per cent of the registered capital. The only large item left for privatisation is Postabank, the country's second largest retail bank. (See *Financial sector* below.)

The state still owns some large strategic companies such as MVM, the main electricity grid company, the railway company MAV, and 25 per cent of stakes in oil and gas company MOL and pharmaceutical company Richter Gedeon. The government is expected to reach a decision on the possible privatisation (or further privatisation in the case of MOL and Richter) of these entities in the near future.

Investment policy and incentives

The 1988 Act on Investments of Foreigners in Hungary governs the establishment and operation of companies with foreign participation, and grants significant rights and benefits to

foreign investors. It guarantees national treatment for foreign investments and abolishes the general requirement of government approval. It also provides protection against losses resulting from nationalisation, expropriation, or similar measures, and guarantees free repatriation of invested capital and dividends.

Over the last few years, in an effort to harmonise with EU regulations, the government has been shifting to a strategy of supplying investors with more direct support, instead of general tax and grant incentives. Because of EU anti-discrimination rules adopted by Hungary, there are also no "foreign" investment incentives per se. All incentives are available to any investor, regardless of nationality, who meets the stated criteria.

FDI by sectors, 1998 (stock)

Sector	% of total
Manufacturing	38.4
Electricity, gas, steam and water supply	14.8
Wholesale and retail trade, repairs	12.3
Financial intermediation	10.9
Real estate, renting and business activities	9.8
Transport, storage and communications	7.1
Construction	1.9
Hotels and restaurants	1.8
Agriculture, forestry, fishing, mining, quarrying	1.4
Other activities	1.6
Total	100.0

FDI by country of origin, 2000

Country	% of total
Germany	28.0
Netherlands	15.5
USA	12.2
Austria	11.7
United Kingdom	6.4
France	6.1
Italy	3.2
Switzerland	2.9
Belgium	2.7
Japan	1.9
Other	9.4
Total	100.0

Source: National Bank of Hungary

Concerning general tax incentives, Hungary provides a 10-year, 100 per cent corporate tax holiday for all large investments (more than HUF 10 billion (US\$ 42 million) or HUF 3 billion (US\$ 12.6 million) in designated underdeveloped areas). This allowance is currently valid until the 2011 tax year, which means that investments made after 2001 may not enjoy the full 10-year tax holiday. This incentive exempts the company from Hungary's 18 per cent corporate tax.

Additional incentives include:

- regional incentives offered in all of Hungary's 19 counties as long as the supported project creates at least 100 jobs. The incentive may take the form of a grant, loan, or interest support, and all allocations are used strictly for greenfield investment projects;
- incentive package for SMEs, including foreign-owned firms, in the form of interest support for capacity-increasing investments;
- sectoral support for tourism and agriculture;
- employment incentives including wage support (for 300 workers or more), training subsidies, wage subsidies, social security cost reimbursement, and commuting expenses;
- export credit subsidies of up to 50 per cent of interest expense;
- customs-free zones; and
- subsidies for export promotion activities.

In recent years, the government has strengthened measures to develop and make **investment parks** more attractive for foreign investors. Hungary has 112 industrial parks, but not all of them are equally developed. The seven largest, all located in western Hungary, account for 80 per cent of the production and 60 per cent of the employment of all parks combined. AHIP, the Association of Hungarian Industrial Parks, intends to change this situation by performing some collective promotion for the parks, offering to arrange low-interest financing to help businesses move into industrial parks and providing assistance to Hungarian SMEs aiming to secure contracts with large multinationals.

More information on industrial parks, and on the government's support programme for SMEs can be found on the web site of the Hungarian Ministry of Economic Affairs: www.gm.hu

Foreign-owned companies that are Hungarian legal entities may only **acquire real estate** that is "required for its economic

activities." However, this does not prevent foreign entrepreneurs from engaging in property development. The Land Law restricts the purchase of **land** by foreigners to 6,000 square metres, but allows for leases of up to 300 hectares for a maximum of 10 years. Regarding the terms of land lease, according to the recent Hungarian land law, there are certain exemptions from the 10-year maximum period. In the case of forests, vineyards and orchards the term of a lease can be longer, taking into account the economic characteristics of usage. Only Hungarian citizens can purchase arable land at present. According to recent calculations, agricultural land prices in the European Union are 5-40 times higher than those in Hungary. Fears about land speculation have prevented any movement on this issue, and no changes are expected until EU accession at the earliest. Hungary is currently negotiating with the EU for a 10-year derogation on foreign ownership of agricultural land.

Hungary is already well advanced in the liberalisation of medium and long-term **capital movements**, but further advances are still required before EU membership. The latest EU progress report on Hungary stated that liberalisation should be extended to the system of restrictions on short-term operations, transactions denominated in HUF and deposits abroad, as well as to capital movements.

Eastern Hungary

Hungary's first 10 years of foreign investment have been concentrated in Budapest and major areas of western Hungary, due to their more developed infrastructure and proximity to the European Union border. At the same time, areas of eastern Hungary, particularly the north-eastern cities of Nyiregyhaza, Debrecen, and Miskolc, are drawing increasing interest from foreign investors, since important measures were taken to make the region more attractive. Most significantly, there are special incentives for doing business in eastern Hungary, which qualifies as an "underdeveloped" area. (See *Investment policy and incentives* above.) Another measure being taken is the concentrated development of industrial parks with the help of government funds. The region is also becoming more accessible, as the government has re-started motorway development and other infrastructure investments. Finally, due to the high level of manufacturing investment, skilled labour has grown scarce in many western counties, so foreign investors are increasingly turning to eastern Hungary, which still offers a large and well-trained workforce.

Hungarian Investment and Trade Development Agency

The Hungarian Investment and Trade Development Agency (ITDH) can provide information and other support in foreign investment promotion and export promotion and trade consulting. It operates Hungary's foreign trade service network consisting of 38 offices in 34 countries.

ITDH can be contacted as follows:

1051 Budapest,
Dorottya utca 4.
Tel: +36 1 318-0051
Fax: +36 1 318-3732
E-mail: itd@itd.hu
Web page: www.itd.hu

Trade and markets

Hungary, which is a founding member of the WTO, applied tariffs in 2000 that average 12.4 per cent on all products, 33.5 per cent on agricultural items, 15.0 per cent on fishery products and 7.4 per cent on industrial products. The average most-favoured nation (MFN) duty rates have been gradually decreased, from 13.6 per cent in 1991 to about 8 per cent in 2000.

The country has an association agreement with the EU that came into force in 1994. The agreement provides for an asymmetrical liberalisation of trade over the next five years. Tariffs for industrial products imported from the EU are being gradually eliminated by the end of 2001. Hungary is also a founding member of CEFTA (Central European Free Trade Agreement), which also includes the Czech Republic, Slovakia, Poland, Bulgaria, Romania and Poland. About 90 per cent of all industrial products are being traded free of duty between CEFTA members. Two new free trade agreements with Latvia and Lithuania entered into force in January and March 2000, respectively.

In February 2000, responsibility for external economic policy, including customs policy, was transferred from the Ministry of Economics to the Ministry of Foreign Affairs. Hungary has traditionally been strongly oriented towards foreign trade. The EU countries account for around three-quarters of exports and two-thirds of imports. Germany is the country's most important trade partner, followed by Austria and Italy. Russia is still a relevant source of imports, as the provider of a large part of the country's

energy resources. Trade has been diversifying over the last few years. Apparel and clothing accessories, automobile parts, and machinery and equipment have become important exports, with the re-export of processed imports playing a particularly large role in these categories. The share of food industry products, although still a major element, has dropped in recent years.

Taxation and social security

Under the current tax regime, Hungary has relatively high individual income taxes with a top rate of 40 per cent, but the corporate tax rate (18 per cent) is one of the lowest in the region. The current basic VAT rate is 25 per cent, with a preferential rate of 12 per cent for food, energy and some other items. The employer's social security contribution rate was 33 per cent in 1999 and 2000, and was brought down to 31 per cent at the beginning of 2001. In 2000, there were some minor modifications to the existing regime, such as new tax allowances for families, and some small changes were made to taxation of the self-employed, refund processing for VAT, and excise duties on wine and cigarettes.

Over the medium term the government has promised to make the tax environment more predictable, reduce the tax burden and narrow the differences between taxes on various types of income. A reduction in social security contributions is also planned: they will be reduced by 2 per cent to 31 per cent in 2001 and then a by further 2 per cent to 29 per cent in 2002.

The country's social security fund, made of pension and health funds, has been running large deficits over the last few years and the government has been working on reform of the system. However, the Pension Insurance Fund had a year (1997) in surplus as well. From 1998 onwards, the government budget has refunded the deficit of the Pension Insurance Fund in accordance with the law on public finances. A successful reform of the pension system has already taken place, with a three pillar pensions system in operation since January 1998 (Pillar I – the pay-as-you-go state system; Pillar II – contributions to private funds; Pillar III – voluntary mutual pension funds).

Exports and imports by group of countries

Group of countries	OECD	EU	Germany	EFTA	CEFTA	CIS	Russia
Share of exports, %	87.5	75.7	37.9	1.4	8.2	2.4	1.5
Share of imports, %	75.9	58.7	26.0	1.5	7.5	8.9	7.7

Source: MTI-Econews



Major sectors of the economy

Most of the Hungarian enterprise sector has developed solid foundations through restructuring and high levels of foreign investment. The majority of the companies have grown rapidly in 2000, thanks to increased productivity and the strong demand in EU export markets. Electronics and car manufacturing have been among the most energetic, as several multinationals that settled in Hungary from the early 1990s continued to invest and expand their production facilities. The liberalisation of service sectors, such as telecommunications and energy, will create huge opportunities for growth and investment in the near future. A new and important development of 2000 was the regional expansion of several of Hungary's most successful firms.

Telecommunications

In the 1990s, telecommunications has been one of the fastest growing sectors of the economy. The full privatisation of the primary operator, MATAV, allowed for modernisation of basic infrastructure. Selling mobile frequencies has created a competitive and rapidly growing mobile market, and finally liberalising the market for data transmission has attracted a third wave of foreign investment and begun to offer sophisticated services and real choices to companies. The sector is far from exhausting its potential, as growth is expected to be 15 per cent annually in the coming years, with Internet services and mobile telephony to lead.

In the near future important changes in telecommunication regulations are expected to take place. Regulators have stated that they will liberalise most of the market by 1 January 2002. On that date, long-distance and international services now held under MATAV's monopoly will be open to competition.

In its latest report the EU concluded that there is already a high level of alignment with EU regulations in the Hungarian telecommunications market. Further progress is requested regarding the liberalisation of the fixed line telephony network as well as the reform of the postal services. In both areas the Hungarian government is committed to proceeding with liberalisation in the very near future.

MATAV (the Hungarian Telecommunications Co.) dominates the Hungarian fixed line telephone system. Phone penetration had reached 40 per cent by the end of 2000. The company holds a monopoly on domestic fixed line service and on the provision of long distance and international public switched services. MATAV was privatised in 1993, when 60 per cent of its stakes were bought by MagyarCom, a consortium between Deutsche Telekom (Germany) and Ameritech (US). Deutsche Telekom later obtained Ameritech's shares in MagyarCom, and thus became the sole owner of MATAV. The company is basically 100 per cent privately owned as the state only holds one voting golden share. MATAV's ambitious investment

programme, started in 1995, resulted in an impressive growth in the volume and improvement in the quality of services offered. The annual growth rate of fixed line customers has been over 10 per cent in the last five years and digitalisation has reached over 90 per cent. MATAV continues to maintain a strong level of profitability. The company's net earnings were US\$ 210.9 million in January-September 2000, representing a 14 per cent rise over the same period of 1999.

Under a plan begun in 1999, MATAV intends to invest US\$ 1.68 billion by the end of 2001, largely in Internet technologies. The management claims that as growth prospects regarding the fixed line market are very limited, MATAV will have to refocus on growth areas such as mobile telecommunications, and also aims to be the market leader in Internet-based services and data communications. The company's Internet provider is called MATAVnet and it owns a controlling share in leading mobile operator Westel.

In 2000, MATAV expanded in regional markets as a consortium it led won a tender for a 51 per cent stake in Maktel, the sole fixed-line and mobile operator in FYR Macedonia.

The ongoing liberalisation of the telecom sector has enabled the entrance of alternative fixed line local and long-distance operators such as PanTel, Vivendi, Novacom and GTS. The services offered by these operators are aimed at satisfying the voice and data communication needs of medium-sized and large businesses. The leading company PanTel, was formed in 1998, with majority ownership by a Dutch company, KPN Telecom (62 per cent). The company is using the existing cable network of the national railway company, MAV, which has a 10 per cent share. In December 1999 PanTel won a bid to provide Magyar Posta with IT services, the first major state contract not to go to MATAV. GTS is the Hungarian subsidiary of American based Global Telesystems Group, Inc.

The privatisation of Antenna Hungaria (AH), the state-owned broadcasting company has been proceeding. An international offering of AH shares failed due to a lack of interest from institutional investors in November 2000. The failure was

attributed to unfavourable market conditions. Following these events, the government is currently considering several options for the future of AH, including a second public share offering if the Hungarian stock exchange recovers, or a sell-off to a strategic investor. There has reportedly been interest in AH among several strategic investors including Vivendi (France) and BT (UK).

Mobile telephony

Hungary has a well-developed cellular phone market. The rapid growth in mobile phone service subscribers continued in 2000, with the market penetration rate increasing to 25 per cent by September 2000. The current market leader is Westel, a 51 per cent unit of MATAV, which now holds an option to purchase a 49 per cent stake currently held by Deutsche Telekom. The second largest operator is Pannon GSM, in which Dutch telecom company KPN holds a 45 per cent share. The latest entrant to the market, Vodafone, which became operational in 1999, is the local unit of UK mobile company Vodafone AirTouch (US-UK), in a joint venture with Antenna Hungaria, RWE (Germany) and Magyar Posta.

Hungary intends to launch a tender for third generation UMTS licences in late 2001. The authorities are planning to offer three licences for sale.

Internet

Internet services are a growing element of the Hungarian telecom sector. Currently there are approximately 80,000 dial-up subscribers being serviced by some 30 Internet Service Providers (ISPs). Four ISPs – MATAVNet, Elender, Euroweb and Datanet – account for 84 per cent of the market. MATAVnet is the subsidiary of fixed line telecom monopoly MATAV. Elender is owned by PSINet (US) and DataNet is owned by GTS (US). PanTel, alternative telecom provider, holds Euroweb. However, the provider end of the market is expected to change quickly in the future as new companies rich in capital and experience are entering. Two recent examples are UUnet, a subsidiary of WorldCom (US) and Sweden's leading ISP, Telia International Carrier, which both launched services in the second half of 2000. The leading providers concentrate heavily on corporate clients.

In addition to Internet access services, the most promising services for development are content-providing, hosted applications, Internet telephony and E-commerce. Business-to-consumer E-commerce is currently relatively underdeveloped, but is forecast to increase rapidly. Currently, there are about 200 Hungarian companies selling their products over the Internet. Business-2-Consumer transactions are forecast to

reach a value of US\$ 1.85 million in 2000, US\$ 4.1 million in 2001 and US\$ 9.3 million in 2002.

The regulatory environment in Hungary as it relates to the Internet is at an early stage of development. Internet related issues are partly regulated by laws governing related technologies (i.e. telecom, media, etc.). Regulations on electronic documents and authentication of digital signatures are currently being drafted, with passage expected within two years.

Hungary's IT stars

Hungary has developed an advanced software industry. A large number of leading foreign IT firms (GE (US), Siemens (Germany), Motorola (Italy), Philips (Holland), Nokia (Finland)) have established software development centres in Hungary. In addition, several domestic companies have also become important players both in the domestic and international markets. Among the largest Hungarian software houses is KFKI, which has a major stake in telecom-munications company PanTel. Hungarian Equity Partners, an EBRD-sponsored fund, is a major shareholder in the company. Another well-known Hungarian software company is Graphisoft, which is a leading provider of computer-aided design (CAD) software solutions for the architectural profession and the building industry. Founded in 1982, Graphisoft is ranked today among the largest AEC CAD software developers in the world, with 12 offices worldwide in addition to its headquarters. Graphisoft's flagship product, ArchiCAD, is used by more than 75,000 architects worldwide and distributed in 25 languages and 80 countries. Shares of Graphisoft are traded on the Frankfurt Stock Exchange Neuer Markt and also on the Budapest Stock Exchange since spring 2000, with an aim of tapping increasing investor interests at home as well. The company has been expanding with two new acquisitions abroad in 2000. It bought Drawbase Software (US), a computer-aided facilities management software provider, as well as a minority stake in ExpressionTools (Japan).

Software Export Marketing Programme

The objective of the Software Export Marketing Programme is to help Hungarian IT and software companies to enhance their international activities. In the framework of the programme, launched in 1995, various marketing activities have been carried out to introduce the participant Hungarian companies to international markets, aiming at trade and investment promotion, co-operation, outsourcing and image building. Information on Hungarian IT firms can be accessed on the programme's homepage, www.itd.hu/software

Automotive

Hungary's automotive industry is one of the most dynamic industrial sectors in the country. Its emergence and growth is based on large-scale investments made by leading auto manufacturers, such as GM-Opel (US-Germany), Ford (US), Audi (Germany) and Suzuki (Japan). These companies have become real giants of the Hungarian economy, with, for example, Audi ranking as the second largest company in terms of net sales and the first in terms of exports in 2000. The development is especially impressive, as under communism Hungary had no domestic car industry, with the exception of bus and truck manufacturers Ikarus and Raba. Parts manufacturing and car assembly are equally important sub-sectors. Production is highly export oriented, as the small size of the country only permits a limited demand. A dominant share of assembled cars is sold in foreign markets, and many car parts are sent for assembly to plants located outside the country.

Ikarus

The former flagship of the Hungarian automotive industry, bus maker Ikarus, had a difficult transition, but in 2000 sales and orders increased significantly. Ikarus's standing largely improved in its earlier traditional market, the former Soviet republics. The company delivered 368 buses and assembly kits to Russia in 2000 and also signed a deal with the city of Kyiv in Ukraine to deliver 103 buses. As a further boost, together with Raba, Ikarus won the US\$ 11 million public procurement tender issued by the association of national long distance Volan bus companies. The two companies will supply a total of 70-90 buses.

Raba Rt. restructuring with EBRD support

One of the success stories of the Hungarian domestic industry is the turnaround and privatisation of Raba Rt, the local truck and vehicle parts manufacturer. The company was transformed from a former flagship state-owned company, servicing exclusively COMECON markets, into a publicly owned and listed enterprise, competing in global markets. The process received important support from the EBRD through a capital increase at the time of the company's privatisation in 1997. As part of the privatisation process a further 50 per cent of Raba was sold to a consortium including DRB Hicom Group of Malaysia, the European Bank for Reconstruction and Development, the First Hungary Fund of Jersey

in the Channel Islands, Graboplast, and Raba Management Investment Kft (Ltd). This initial equity purchase was followed by a successful public offering of the remaining shares of the company in 1998. At the moment, Raba is one of the 10 largest Hungarian manufacturing companies and the largest locally owned participant in the automotive industry. The company's core business is component manufacturing for trucks, buses and personal cars, with axle production providing the largest revenues. Raba's main customers include Dana Corporation (US), Meritor (US), John Deere (US) and Magyar Suzuki Rt. The proceeds from Raba's privatisation were used to partly finance the company's 1998-2001 capital expenditure programme. It included the procurement of modern machinery and technology to improve productivity and quality and expand the product range. The most important project was the completion of a major efficiency increasing programme at its axle subsidiary.

The restructuring process resulted in increased profitability for the company: operating profit in 2000 was 25 per cent up on 1998, while per capita operating profit saw a 54 per cent increase over the same period. There has also been a marked increase of confidence of foreign investors in Raba, clearly reflected by the growing volume of shares held by foreign investors. Foreign investors held 46.2 per cent of shares in November 2000, as compared to a 32.9 per cent foreign ownership registered at the beginning of the year.

Car parts suppliers

There are about 300-350 companies involved in the manufacture of components for the automotive industry, including main parts, modules and electrical articles, as well as glass, chemical and metallurgical articles etc. These can be classified into 2 categories: local plants of large foreign auto manufacturers and domestic SMEs specialised in this area. Among the Hungarian-based multinational car manufacturers Magyar Suzuki Rt. has the most suppliers. Among its 50 partners there are small enterprises and multinational corporations alike. Local content in the Suzuki cars, including final assembly, accounts for 65 per cent. To further encourage the increase of domestic value-added in the automotive industry, the government launched a Subcontracting Programme in 1998 under the direction of the Ministry of Economic Affairs. The basic intention is to provide support to the enterprises aiming to act as suppliers to Hungarian large enterprises and multinational concerns. Information about the programme is available on the Ministry's web site: www.gm.hu

Automotive industry news

Opel, the German based subsidiary of General Motors (US), established its first car assembly, engines and spare parts plant in Szentgotthard in 1992 with the support of the EBRD. The plant's current capacity is 400,000 engines and 15,000 vehicles (Opel Astra) annually. The plant also manufactures painted bodies and cylinder heads for the Opel assembly plant in Poland and other European Opel plants. OPEL/GM Manufacturing Hungary Ltd. soon became one of the top companies and largest exporters out of Hungary, and has sold over 50,000 Astras in the country over the past six years. In 1998 a new gearbox factory was added to the facilities. As the latest investment, Allison Transmission, a subsidiary of General Motors, opened a HUF 7.5 billion (US\$ 24 million) factory in Szentgotthard to manufacture automatic gearboxes for buses and trucks. Opel also set up a regional trade centre in Hungary in 1999, which organises sales and marketing of Opel cars in Hungary and in the entire south-east European region. GM/Opel's total investment in Hungary is worth almost DEM 1 billion.

Suzuki (Japan) established its Hungarian firm, Suzuki Rt., in 1990, and was one of the first large-scale foreign investors in the country. The Suzuki plant, built as a greenfield facility in Esztergom (northern Hungary), began operations in September 1992. It is Suzuki's principal European production site, manufacturing Suzuki Swift and Suzuki Sedans, and since

January 2000 a new model, the Wagon R Ride vehicle. The success of the plant is illustrated by its constant rise in capacity. The company plans to raise its production from 80,000 cars in 2000 up to 90,000 in 2001 to keep up with growing western European and domestic demand. Around 70 per cent of production is exported to EU countries. The Suzuki Swift model has become a market leader in its category in Hungary, mainly because of its competitive price and aggressively growing dealer network. The plant, which is supplied by some 40 locally owned companies, employs 1,500 people. The management is also considering moving engine production from Japan to Hungary in the near future.

Audi Hungaria Motor Kft., the local subsidiary of Audi-Volkswagen (Germany), was founded in April 1993. It started production on the site of facilities previously owned by domestic truck producer Raba in Gyor, north-west Hungary. Originally, the plant only produced motors for Audis, Volkswagens, Skodas and Seats. In 1998, Audi launched full production of TT Coupe sports cars, assembling 13,000 in that year. The company expanded annual capacity to 50,000 in 1999, and also started production of the convertible TT Roadster model in the third quarter. A total of 8,557 Roadsters and 44,022 Coupes were manufactured in 1999, while in 2000 the company aims to produce 25,000 units of each model. The chassis of TT models are manufactured in

Germany and then transported to Gyor for final assembly. The company will start the assembly of A3 models in the first quarter of 2001, and plans to assemble 15,000 over the year. Audi's total investments at its Gyor facilities since 1993 had reached DEM 2 billion by the end of 2000. The company ranks second on the list of the largest Hungarian companies in terms of net sales. In terms of export sales, Audi is the largest firm with HUF 720.3 billion in 1999.

Ford Hungaria Kft., subsidiary of the American carmaker, has been operating in Szekesfehervar, central Hungary) since 1992. It manufactures fuel pumps, magnetic starters and gears. The plant supplies its products not only to European Ford plants, but also to plants in South America and Japan, and to Mazda (various west-European assembly plants), one-third of which is owned by Ford. Ford's total investment had reached US\$ 200 million by the end of 2000. As the latest related investment, Visteon, the car parts unit of Ford Motor, has announced that it will build a factory for the production of car air-conditioning systems. The facility will come online in 2002 and will be built with a US\$ 62 million investment. In 2000, Ford also announced plans to relocate its south-east European sales unit to Budapest from Warley, UK, in order to bring its operations closer to the markets.

Sales of top 10 Hungary automotive manufacturers and importers

Manufacturer	1999	2000	% change
Suzuki	28,072	31,926	-12.08
Opel	20,559	19,555	+5.13
Volkswagen	11,201	10,456	+7.13
Renault	10,139	7,514	+34.93
Fiat	8,463	7,775	+8.85
Peugeot	7,815	5,655	+38.20
Skoda	7,064	5,951	+18.70
Daewoo	6,623	7,752	-14.57
Toyota	5,698	4,812	+18.41
Ford	5,316	7,649	-30.51

Source: Vilaggazdasag

Electronics

The electronics industry has developed into a strong magnet for investment in the 1990s, as the world's leading electronics companies (Ericsson, Flextronics, IBM, Nokia, Philips, Samsung, Siemens, Sony, etc) have invested heavily into the establishment of manufacturing and assembly activities in Hungary. Initially, investments were primarily in assembly plants, but later the production of parts and end products became equally important, and some companies also developed R&D facilities in Hungary. In 2000, the positive trends continued, as most of the investors poured profits back into their businesses and increased their investment.

The industry has a very wide range of products, the most important of which are telecommunications equipment, computer hardware, electrical components for automobiles and household appliances. As the capacity of the domestic market for absorbing goods is still rather modest, what really drives the industry is exports. Of the 20 Hungarian companies with the highest exports, eight are manufacturers of electronics products.

Flextronics, a Singapore-based electronic engineering giant, announced in January 2001 plans to begin the production of Microsoft's Xbox video game consoles at its Sarvar plant in July 2001. Hungarian production will be sold in Japan and later in Europe. The order valued at US\$ 3 billion, will make Flextronics Hungary's largest exporter and the production will generate around 5,000 new jobs. Flextronics has a long presence in Hungary. It has six companies and its latest investments include a new plant at Zalalovo for the production of mobile phones, CDs, CD drives and

computer parts. Another ongoing project is the building of a new plant in Nyiregyhaza (north-east Hungary) to assemble and manufacture electronic spare parts.

Leading investors in electronics

Philips Hungary, the local subsidiary of the Dutch electronics giant, was established in 1989, and now comprises 18 separate entities. It initially started production by using the plant of the bankrupted domestic electronics company Videoton in Szekesfehervar, but later it made several greenfield investments. It is now the third largest exporter and the fifth largest company group in the country. The parent company has so far invested € 140 million in Hungary. Philips Hungary currently employs 9,500 workers. In 2000, the company continued its expansion, opening a new plant at Gyor (north-west Hungary) for the production of mechanical components for CD writers. Philips also announced the establishment of a new distribution centre in the Szekesfehervar industrial park (south of Budapest) with an investment of US\$ 10 million. The facility will later be developed into a central and east European regional distribution centre.

Hungary is among the key production locations of **Nokia**, the Finnish high-tech manufacturer. The company's first and largest facility is its plant in Pecs, which manufactures monitors. Its newest mobile telephone factory started production in early 2000 in Komarom (northern Hungary). The plant was built with a US\$ 86 million investment. Nokia has also brought several of its suppliers into Hungary, including Japan's electronics producer Sanyo and Finnish plastic parts manufacturer Perlos. The company also has an R&D centre concentrating on software development in Debrecen (eastern Hungary).

Germany's **Siemens** is among the largest electronics manufacturers operating in the country. The Hungarian Siemens empire (altogether more than 20 companies) are engaged in various branches of the industry, such as communication, transportation, information technology, medical instruments and energetics. The company's expansion in Hungary was largely facilitated by the winning of several government contracted projects, including providing electronic equipment for police headquarters, MAV (Hungarian State Railways) and several projects that form part of the Hungarian army's modernisation programme. So far, Siemens has invested DEM 500 million in the country.

Tyco Electronics Hungary Kft., part of US based Tyco International, has three plants all located around Budapest. At Bicske, the company produces spare parts for industrial and telecommunications purposes, and another plant in Vecses

manufactures sockets for the automotive and electronics industries. The Esztergom plant supplies the automotive industry with electrical parts. In 2000, the company expanded several of its production facilities.

Samsung Electronics Hungary, the local subsidiary of South Korea's Samsung, produces television sets in its factory at Jaszfenyaszaru (eastern Hungary), the company's only TV manufacturing plant in Europe. Samsung raised its TV production from 1.2 million in 1999 to 1.7 million in 2000. The company also started building a new US\$ 21 million electronic parts plant near Budapest.

Energy

Hungary has implemented far-reaching market reforms in the energy industry in the last decade. The privatisation of the sector, labelled as one of the most radical in the history of continental Europe, triggered a major influx of foreign working capital that resulted in improved efficiency and inward investment. The next task for the country is the liberalisation of its energy sector, which is required not only to qualify for EU membership, but also to maintain economic competitiveness by keeping power costs in line with the EU.

Starting in 1995, Hungary rapidly privatised a large part of the energy sector. All six electricity distribution companies were sold to foreign investors and all but two of the power generation companies were privatised. The state retained only the Paks nuclear power station and the coal-fired Vertes plant. MVM (Magyar Villamos Muvek), the company that operates the national electricity grid and has a monopoly on exporting and importing electricity, has also remained in state hands, and options for its future privatisation are being discussed. MVM drew up long-term power purchase agreements (PPAs) with each generation companies, designed to give the new buyers confidence that they could sell their output at a profit. According to the privatisation agreements, the government guarantees profits for the privatised distributors and generators equal to an 8 per cent return on assets. International firms operating in the electricity-generating industry include Powergen (UK), AES (US), EDF (France), RWE and EVS (both Germany). Recent ownership changes included the sale of Budapest Power Plant by Fortum (Finland) to France's EDF group, and also PowerGen is reportedly planning to sell off its Hungarian subsidiary, Csepel Power Plant, in line with its strategy of divesting in non-strategic markets in order to finance its merger with US-based LG&E Energy Corp.

Hungary is in the process of adopting a liberal and competitive energy market model. The government is currently debating a draft version of the electricity law designed to oversee the full liberalisation of the market. As a first step, the law would call for a limited test market opening for about 15 per cent of total annual consumption for 2002. This would give the largest industrial companies the opportunity to buy electricity from any supplier. The plan includes two alternative scenarios: fast liberalisation, to be completed in 2005, and a slower process, to be completed in 2010-12. The choice of scenarios will depend in part on the outlook for and timing of EU accession.

One of Hungary's priorities is to increase its relatively low level of energy efficiency, a problem that has been criticised by the EU. A new € 6.2 million energy efficiency programme was adopted in 1999. The private sector is achieving some success in this area with the help of IFIs. For example, between 1995 and 1997 the EBRD provided financial assistance to Prometheus Rt. and Honeywell Hungary, two leading energy service companies (ESCO). ESCOs work with clients that do not have funds to install energy-saving equipment, in a way that they help to invest in the equipment necessary to generate savings. Loans are then repaid through contractual arrangements, known as Energy Performance Contracts. These convert the savings made by the clients' reduced energy costs into a flow of revenue. The EBRD's financial packages were used for energy conservation services to SMEs as well as to public buildings (prisons, hospitals and schools) and district heating projects.

Hungary has four 440-megawatt (MW) Soviet-designed pressurised-water nuclear reactors operating at Paks, and nuclear power accounts for about 30-35 per cent of total domestic electricity production. Paks maintains an excellent safety record, ranked in the top 10 per cent of reactors worldwide. As a result of an extensive upgrading programme started in 1996, the power station now meets international and EU requirements for safety standards and for hazardous emissions. The authorities and management are currently investigating a long-term solution for nuclear waste disposal.

According to the latest EU Progress Report, Hungary has already adopted the main principles of the internal energy market and set a framework for further alignment with the *acquis*. Increased energy efficiency, tariff re-balancing and further liberalisation are the issues where more progress is required.

Agriculture and food industry

Agriculture has traditionally played a very important role in the economy. The country has a favourable climate and fertile soil conducive to crop production. It is self-sufficient in almost all agricultural products and during the communist era exported about one-third of all output. A wide variety of crops are produced, including wheat, maize, rice, fruit and vegetables, rye, barley, oats, sunflower seeds, and sugarbeet. Dairy and livestock production is also important.

The post-communist transition has been difficult for the sector. Agricultural output and the share of the sector to the economy and employment declined until the mid-1990s, but a recovery began in 1995. Currently, it represents 5.5 per cent of GDP and employs 7.1 per cent of the working population. The ownership structure has also changed greatly, as the sector includes nearly 960,000 private holdings and more than 8,200 enterprises engaged in agricultural activities.

The budget of the Ministry of Agriculture has been steadily increasing in the last two years. However, direct agricultural subsidies and price supports are still at a relatively low level compared to EU standards. The largest financing is for credit and export subsidies, the latter being responsible for almost half of state expenditure on agriculture.

The single most important issue for the sector is preparation for EU membership, which will involve inclusion in the EU's Common Agricultural Policy (CAP) regime. The latest EU Progress Report on Hungary claims that the basic structures of the agricultural acquis are in place, but the administrative structures required for the implementation of the CAP still need to be strengthened. Alignment has to be speeded up especially in the veterinary and phytosanitary sub-sectors.

The EU's pre-accession agricultural and rural development subsidy programme, SAPARD, includes two measures that are aimed at investments in agricultural production and processing. For the full seven-year period (2000-06) about 600-800 food industry and about 1,100 farm investment projects are expected to be implemented. The total non-returnable public support per project can be a maximum of € 320,000 for food industry and € 160,000 for farm investment projects. This contribution is shared between the EU and the national budget according to a 75:25 per cent ratio. Those eligible for the SAPARD funds should have a proper business plan, proof that their own required resources are available (mostly 60 per cent, and in certain cases 70 per cent, of the total eligible costs),

and that the company has no outstanding debts. SMEs (with less than 250 employees in the food industry or 50 employees on farms) are given priority.

Hungary's agricultural sector has received significant financial assistance from several IFIs and international organisations. The EBRD's Agricultural Restructuring project has provided € 75.8 million worth of financing to four commercial banks for on-lending to SMEs in the agribusiness sector. The EU PHARE programme has also played an important role, with support for the creation of a Rural Credit Guarantee Fund worth € 20 million. The fund has so far provided guarantees for loans to more than 1,200 SMEs in food processing and agriculture in 2000.

Food industry

Hungary has a well-developed food industry that makes up around 17 per cent of industrial production and 10 per cent of exports. Following several years of decline and stagnation, the industry recorded output growth in 2000, as a result of growing demand from abroad. Food exports could rise 7-8 per cent in 2000, principally as a result of more deliveries to Romania, Croatia and CIS countries. Analysts predict that the industry will only cope with the recession by increasing export volume, as growth on the domestic market can be no more than 1-3 per cent annually.

According to the report of the Hungarian Food Producers' Association, the food industry is prepared for EU accession and will be one of the industries to benefit most from EU membership. The quality gap between products made for the domestic market and those made for export has almost entirely closed.

One of the most important characteristics of the sector is its high level of concentration. According to market analysts, competition has remained intense in the meat, grain, baking, wine, and cooling and canning industries, where there is permanent oversupply. At the same time, a highly competitive milk market has consolidated to a point where four companies (Gala, Parmalat, Nutricia and MiZo) are responsible for some 70 per cent of sales, while many small enterprises share the rest. The market is even more concentrated in the soft drink, sugar and beer industries, with only a couple of firms controlling each field. The same situation is characteristic of the coffee, confectionery and spirits markets. Privatisation has left intact the oligopolies, the dominance of a few large players, in the tobacco industry and in the edible oil sub-sector.

This trend continued in 2000, as large food processors engaged in mergers and acquisitions, regarding them as the best strategy to compete with large-scale food companies in the EU. An example is the acquisition of Stollwerck-Budapest Kft., by Gyori Keksz, a confectionery owned by United Biscuits (UK). With the increase of capacity, the company intends to boost its position on the market.

One of the most renowned Hungarian food companies, Pick Salami Herz, founded in 1869, is also seeking acquisition targets in Hungary, Poland, and other neighbouring countries. The company's management sees regional expansion as partnership with a foreign strategic investor as the best way forward. Pick's activity covers almost all meat industry activities, from pig fattening, slaughtering and manufacturing to domestic and foreign trade. It has about 25 per cent of the domestic cured meat market, and overseas sales accounting for 42 per cent of total sales in 1999. Besides the parent company there are three other firms in the group, HERZ Salami Factory, Ringa Meat Company and the Szegedi Paprika Company.

Wine

Hungary has rich traditions and excellent natural conditions for wine growing and production. The sector underwent rapid transformation in the 1990s as large wineries formerly belonging to the state were transferred into the hands of private companies. As a result, a large number of very successful medium-sized wine estates emerged, producing high quality wines. The development of the sector is being greatly helped by foreign investors, who have contributed technology and financing to the modernisation of production. Examples include Axa Millesimes (France) and Suntory Ltd (Japan). Transition has been especially successful in the Tokaj region, which is famous for its refined dessert wine, Tokaji Aszu. Thirty per cent of total Tokaji Aszu production is in foreign hands and at the top end of the Aszu categories foreign ownership is nearer 50 per cent. Around 70 per cent of exports go to the EU, a figure that is likely to rise, as Hungary and the EU agreed to establish a duty free export quota on wine and sparkling wine that came into force from 1 January 2000. Accession to the EU will make the market of more than 15 states easily accessible for Hungarian wine makers, but will also mean that established EU winemakers will come looking to Hungary for more customers.

Oil and gas

Hungary is not rich in natural resources and has to import more than 50 per cent of its energy needs. There are modest gas reserves of around 113 billion cubic metres and small oil

reserves in the eastern parts of the country. Hungary has developed a diversified supply of resources, most coming through pipelines from the former Soviet Union, but there is also an oil pipeline to the Adriatic Sea and a natural gas pipeline connecting to Austria.

The oil sector has been fully liberalised and is dominated by the oil and gas giant MOL (Magyar Olaj és Gazipari Rt.), Hungary's largest company and an increasingly important regional player. In the gas sector a number of distribution companies have been privatised, but the sector is still awaiting liberalisation. The government's latest plans foresee a partial liberalisation from 2002 or 2003, initially for large-scale customers. Locally produced gas is currently priced below imported gas, reflecting relatively low domestic production costs. However, following limited pricing reforms introduced from November 2000, the price of gas for industrial producers rose by 43 per cent.

MOL – leading the way for regional expansion

MOL dominates the liberalised and competitive market for importing and marketing oil and its refined products. It has the largest oil retail network representing around 34 per cent of the market and holds an approximately one third stake in TVK Rt, one of Hungary's largest chemical companies. MOL also holds a monopoly in the gas market: the company is the sole domestic producer, dominates imports, owns a network of high-pressure gas transport and collection pipelines, and is the sole gas distributor.

MOL was privatised through an IPO in 1994. Currently, foreign investors hold approximately 55 per cent, domestic investors about 16 per cent and the remaining 25 per cent plus 1 golden share are owned by the state.

MOL has been pursuing an aggressive and ambitious strategy of expansion and diversification in recent years. It aims to become a regional player by reaching out to neighbouring countries with cross-national mergers and acquisitions. In the most important move so far, MOL purchased a 36.2 per cent stake in major Slovak refinery Slovnaft. This is the first major cross-border deal between two locally owned central European companies. Analysts have commented that it may set a precedent for other firms to consider regional partnerships rather than simply look for a western investor. MOL is also planning expansion in the Polish market, where it was reportedly among the bidders for the Gdansk Refinery (Rafineria Gdanska) in January 2001. Rafineria Gdanska is likely to be sold in a package with some 250 filling stations in Poland, which have a 20 per cent market share. MOL also has retail operations in neighbouring Romania, where it holds 3 per cent of the market and has recently announced a large-scale expansion plan.

The two flagships of the Hungarian chemical industry, **BorsodChem Rt** and **TVK Rt**, are also among the largest companies in the country. Both companies are located in north-east Hungary. TVK is one of central Europe's largest producers and processors of ethylene and polyethylene. BorsodChem is a leading producer of plastic raw materials. Beyond the core business it operates further subsidiaries which dominate in the field of plastics processing.

Tourism

Tourism is a successful economic sector in Hungary with large potential for further development. The main magnet for tourists is the magnificent capital, Budapest, one of the great cities of Europe, with plenty of impressive historic buildings and a rich and exciting cultural life. After Budapest the countryside has a lot to offer as well, including well developed spa resorts, famous wine centres, many historic sites, and peaceful and undisturbed rural areas that provide an excellent environment for active tourism, especially for horse riding, fishing, hunting and water sports.

The number of visitors and the income derived from the tourist industry increased rapidly in the 1990s and are still growing. Foreign exchange revenues in Hungary's tourism sector multiplied threefold between 1989 and 1999, and an estimated nine per cent of GDP now derives from tourism. The year 2000 was a particularly good year. In the first eight months, the number of guest nights spent in public accommodation increased to 13 million, 3.8 per cent higher than in the corresponding period of 1999. Tourism revenues came close to € 2.5 billion in January-August, 14.1 per cent more than in the corresponding period of 1999.

Hungary's tourism industry is set to grow by 5.7 per cent per year on average for the next 10 years, according to a study by PricewaterhouseCoopers. Compared to US\$ 9.145 billion in travel and tourism revenues in Hungary in 1999, by 2010 the country is expected to generate US\$ 20.398 billion. The study forecasts 20 million tourists in 2010, and 24 million by 2020.

Spa tourism was recently selected by the government as a segment of the market deserving direct support due to its potential. Hungary is extremely rich in thermal springs, as there are some 135 natural springs with recognised medicinal properties and 35 well-developed spas offering medical treatment. In November 2000, the government announced that it will devote HUF 10-12 billion to the development of spa resorts in the next two years.

Budapest hotel boom

The fastest growing segment of the tourism industry has been top of the range accommodation in Budapest. The total capacity of four- and five-star hotels in Budapest is set to leap by up to 50 per cent by 2002, as many major hotel groups are building or considering building more facilities. The value of four- and five-star hotel projects currently underway amounts to US\$ 600 million. Hotels that opened recently, include a 232-room Hilton (US). New hotels that are expected to open their doors by the end of 2002 include the 215-room Hotel Le Meridien (France) (opened in Nov 2000); the 400-room Corinthia Hotel Royal (Malta); and the Four Seasons Gresham Palace (US). The Four Seasons, which promises to be the crown jewel of Budapest hotels, will be located in a refurbished Art Nouveau building on the banks of the Danube in downtown Pest. In November 2000, the Italian Bescolo Group purchased the New York Palace, one of the most magnificent turn-of-the-century buildings in the city, and will convert it into a 200-room luxury hotel after thorough renovation.

Transport

Hungary has managed over the past few years to narrow the gap between it and the EU countries in terms of transportation, telecommunications and water management. The transport projects have mostly concentrated on upgrading the road system, with the help of budget resources and a large inflow of international capital. In the coming years major expenditure is envisaged on railways, river ports and logistics terminals. Other main priorities are to prepare the state railways and the national airline, Malev, for competition once the European market is opened up.

Rail

Hungary has made progress with the restructuring of its state railways with the aim of improving profitability and speeding up alignment with the EU acquis. The state-owned MAV (National Railways Company) holds the monopoly for rail traffic. The company employs over 50,000 people and benefits from subsidies worth about 0.4 per cent of GDP. Currently the government is discussing various proposals for the organisational restructuring of the company.

The restructuring of MAV is being done with the help of several IFIs. The EBRD provided a loan of € 40 million in 1998 targeted for rehabilitation of freight wagons, refurbishment of suburban coaches and introduction of an automatic passenger ticketing system. Other assistance has come from the EU's PHARE

programme, and the EIB has financed the modernisation of technology and management systems.

Besides MAV, a small number of other companies are also active in the rail sector. The small Gyor-Sopron-Ebenfurt Railway Company, jointly owned by the Hungarian and Austrian governments, operates a track that connects the two countries.

Roads

Upgrading of the motorway network has been an infrastructure priority since the start of transition, and the current government is continuing the work.

The EBRD has played a major role in financing many motorway projects. In 1993 it headed a consortium providing US\$ 200 million for the completion of the motorway linking Budapest and Vienna. The project was completed in 1995.

The EBRD also financed the extension of the M5 motorway that runs south-east from Budapest to Kiskunfeleghaza.

In 2000, the government approved the 10-year highway development plan that outlines further developments. Under the plan, 140 kilometres of new highways and 577 kilometres of two-to-four lane roads will be built at a cost of US\$ 2.2 billion, two-thirds of which may be financed from loans and ISPA (EU) resources and one-third from the central budget. In 2000 alone, loans totalling US\$ 110 million equivalent are required for road projects in addition to US\$ 350 million from Transport Ministry resources and US\$ 220 million from the central budget.

Planned highway projects to be completed by the end of 2001

- construction of the M3 between Fuzesabony and Polgar (eastern Hungary);
- renovation of the M7 between Budapest and Zamardi (south-west Hungary);
- upgrading of the road between Aliga and Zamardi to motorway standard (south-west Hungary); and
- construction of a bridge over the Danube at Szekszard and connecting roads (southern Hungary).

Planned highway projects to start by the end of 2001

- M7 extension to the Croat border;
 - M3 extension to Miskolc (north-east Hungary); and
 - construction of a portion of the M0 Budapest beltway between the M3 and M5 junctions.
-

In the opinion of the Commission, Hungary already takes into account the objectives and priorities of the EU regulations in the field of road transport. However, there is need to further align particularly with provisions on market access, fiscal matters, social legislation, technology, safety and the environment.

Aviation

In 2000, the State Privatisation Agency (APV Rt.) failed to succeed in the privatisation of MALEV, the national air carrier. APV Rt. attributed the failure of the privatisation to the unfavourable situation on the international airline market, the company's losses due to rising fuel costs, intensive competition and the oversupply of airline companies waiting to be privatised.

MALEV has undergone restructuring over the last few years, reducing staff, replacing its fleet of Soviet-made aeroplanes with western ones and rationalising its route networks by increasing the number of its services to west European cities and including several new east European destinations, such as Riga, Sarajevo, and Skopje. The most successfully functioning part of MALEV has been its cargo division. MALEV Air Cargo's performance has been steadily improving since 1994: total revenues for the first half of 2000 indicated an increase of 157 per cent over the same period in 1999. Hungary's strong economic growth offers good perspectives for the expansion of both MALEV's passenger and cargo divisions in the coming years.

Hungary has made significant progress regarding alignment with the EU *acquis* in the air transport sector. Market access and air carrier liability are the two areas where further reforms are needed. The country's only international airport, Ferihegy, which serves Budapest, has modern facilities and recently completed a US\$ 120 million expansion that added 15 gates and raised capacity to 5.5 million passengers per year.

Waste management

Hungary's accession to the OECD in 1996 and its commitment to joining the EU has increased government attention to environmental issues. The country has made impressive progress in the past six years in harmonising its laws and regulations with EU legislation. However, in the EU's latest report on Hungary's preparedness for accession, the environment was singled out as an area that needs improvement. Budget expenditure in this area has been steadily

increasing over recent years, which is likely to open up opportunities for investors and exporters of technology and equipment. Currently, Hungary's spending on environmental projects is equivalent to about 1.2-1.3 per cent of GDP, and the aim is to bring this figure up to the EU average of 2 per cent. According to the Ministry of Environment, the country needs to spend an estimated US\$ 4 billion to conform fully to EU environmental regulations.

At present, imports account for 75-80 per cent of the total waste management market. Major international companies present in the Hungarian waste market include ASA (Austria) Otto (Germany), Rumpold-Pyrus (Austria), ERECO (France), RWE-REM (Germany), and Vivendi/CGE (France). The main end users of environmental/waste technologies are municipalities, the energy sector and processing industries. Waste management technologies are widely used also in the mining sector, agriculture and food processing, petrochemical, chemical and pharmaceutical industries. According to a recent NGO survey, areas where technologies are in high demand include: hazardous waste-site redemption, equipment for sample analysis and waste characterisation, site monitoring, waste collection, transportation and storage. Demand is expected to rise for pollution prevention and waste minimisation equipment for industrial and hazardous waste, and technologies for recycling and resource recovery for industrial waste.

Major international financial institutions including the EBRD, the IFC and the World Bank have been contributing financing to environmental programmes. EBRD investments include the Budapest Bank environmental credit line (ECL) to co-finance environmentally beneficial projects. The EBRD has also supported the privatisation of the Budapest Waste-Water Services.

Budapest Bank environmental credit line

The EBRD in co-operation with other partners has a running creditline to co-finance environmentally beneficial projects. The Environmental Credit Line (ECL) was agreed by the Hungarian Ministry of Environment and Regional Policy, the EBRD and the European Commission in 1995, and became fully operational in 1998. Loans are provided to private companies for environmental protection investments to help these enterprises achieve compliance with regulations and to further improve their environmental performance. The loans can be used for greenfield investments or for upgrading industrial and other production facilities. By the end of 1999, 25 projects had been approved totalling € 13 million.

EBRD support for steel restructuring – OAM Minimill Project

Hungary's steel sector, which has always been relatively small compared to those of Poland and Slovakia, has undergone a difficult transition process. However, following a drastic drop in output in the early 1990s, it has experienced some recovery in the last few years. The industry has largely shifted its product focus and managed to stabilise its role as a supplier for Hungary's growing construction, machinery and automotive sectors.

The EBRD has contributed to the restructuring of the Hungarian steel sector by providing a loan facility to Ozdi Acelmuevek Kft (OAM), one of the country's traditional large steel makers located in north-east Hungary. In 1999 OAM received financing from the EBRD in the form of a € 17.6 million loan, of which € 7.4 million came from Raiffeisen Zentralbank, to continue the modernisation of its production facilities. OAM was one of Hungary's largest steel factories in the 1980s, but after transition a large part of its operations, made up of outdated and inefficient plants, was closed down. The remaining facilities were purchased by Max Aicher GmbH of Germany in 1997. Since then, the new owners have invested heavily in restructuring the company and bringing in up-to-date technology. The EBRD loan helped to finance these efforts, as it was used to partially cover the costs of the reconstruction of a new electric arc steel mill. The facility became operational in August 2000 and greatly added to OAM's good performance in 2000, when it achieved sales of over DEM 85 million. The sound development of OAM is important news for the Hungarian steel sector, which has been in an increasingly critical situation since the 1990s. The project has also helped to preserve jobs in an economically depressed region that is plagued by high long-term unemployment. The EBRD's participation in the project was of crucial importance, as projects to restructure large-scale formerly state-owned enterprises generally have difficulty in gaining access to commercial sources of financing.

Financial sector



The Hungarian financial sector is one of the most mature in central Europe. The banking sector is mainly privately owned and primarily foreign controlled. Challenges for the sector include successful consolidation, improved efficiency, deepening the banking market by accessing SMEs, and development of a wider range of banking services for retail customers. The Hungarian capital markets are among the most liquid in the region, although rather small by international standards. The insurance and newly developed pension fund sectors are also very competitive and are dominated by foreign strategic investors.

Banking sector

Hungary's banking legislation is closely based on EU directives. The Act on the National Bank of Hungary, effective from 1991 and amended in 1997, established the independence of the central bank and gave it responsibility for monetary policy. The activities of commercial banks are governed by Act CXII of 1996 on Credit Institutions and Financial Enterprises, which was amended in 2000, and Act CXI of 1996 on the Offering of Securities, Investment Services and the Stock Exchange. The amendment completed the harmonisation of banking legislation with EU norms, with the exception of rules concerning the internal market that will enter into force upon Hungary's accession to the EU. At this point rules such as the endowment capital requirement for branches of banks from other member states will cease to be effective. A similar harmonisation and modification process is under way regarding regulation of the capital market. The three supervisory authorities for the banking and securities sector, insurance sector and pension funds were merged from April 2000 into the Hungarian Financial Supervisory Authority with a view to providing more effective supervision of integrated financial operators and dealing with new types of risks.

Successful restructuring and privatisation has made the Hungarian banking sector one of the most advanced in the region. There are 39 banks, four building societies, and 226 saving co-operatives and eight credit unions. The concentration of market assets has decreased since the beginning of privatisation in 1993, but remains significant. The market share of the five largest banks has been reduced from 80 to 57 per cent of the system's total assets as a result of strong competition from medium-sized banks. Foreign and joint venture banks, such as CIB Bank (majority owned by Banca Commerciale Italiana Group), Bank Austria Creditanstalt (Austria), Raiffeisen (Austria) and Citibank (US), control around 35 per cent of total assets and are typically specialised in corporate banking.

OTP Bank

OTP, Országos Takarékpénztár és Kereskedelmi Bank, is Hungary's largest bank. Its lead is especially strong in the retail banking market. In the corporate segment, the bank is still a leader, but under much stronger competition from other players. OTP offers a wide range of complimentary products through its subsidiaries, which include OTP Real Estate (real estate management), OTP Building Society, OTP Securities (stock brokerage), OTP Confidencia (pension fund) and OTP Garancia (insurer). OTP does not have a strategic foreign majority owner, which makes it unique among the large Hungarian banks. OTP's gradual privatisation was conducted through the stock exchange and its shares are held by foreign and domestic institutional and portfolio investors. In 1999, the state sold its remaining stake in OTP through a secondary offering, but kept a golden share.

The EBRD has a long-standing co-operation with OTP, which has helped the bank substantially during its transition. The EBRD provided a US\$ 10 million standby loan in 1994 and a US\$ 50 million subordinated loan in 1996. OTP is also one of the participating banks in EBRD's sovereign-guaranteed agricultural credit line for Hungarian banks. Finally, the EBRD acquired 2 per cent of the shares of OTP during the flotation of the state-owned stake on the stock market in 1999.

Foreign investment in the banking sector

Foreign participation in the Hungarian banking system is very high. Foreign banks hold controlling stakes in 27 banks, and the total foreign ownership is around 60 per cent of the registered capital. Foreign investment greatly helped the modernisation of many Hungarian middle-sized banks through the supply of know-how and capital. The first large privatisation deals took place in 1995, as GE Capital (US) and the EBRD acquired stakes in Budapest Bank. In the same year, Magyar Kereskedelmi Bank (MKB) was purchased jointly by Bayerische Landesbank (Germany) and the EBRD. ABN Amro (Netherlands) bought Magyar Hitel Bank (MHB) in 1996. In

mid-1997, K&H Bank was sold to Belgian Kredietbank, Irish Life, an Irish insurance company, and the EBRD. Later, the EBRD sold its stakes in both MKB and in K&H Bank. In 1997, the state disposed of its residual share-holdings in some banks. It sold its stake in OTP, keeping only a golden share with special voting rights. The National Bank of Hungary also divested its 34 per cent stake in the Central-European International Bank with control passing to Banca Commerciale Italiana (Italy).

As a result of increasing competition in 2000, especially in the corporate sector, banks have been turning to the relatively underdeveloped retail market and other riskier market segments such as the financing of small entrepreneurs. By the end of 2000, retail loans had climbed to around 10 per cent of the total, which is still a long way from levels in western Europe, where typically corporate and retail loans are roughly equal. Expansion into the retail segment presents banks with significant set-up costs in terms of information technology and the modernisation of their branch network. As a result, and also because of the rise in competition in the corporate market, profits in the banking sector have decreased slightly in recent years.

It is expected that the number of banks will decrease steadily over the next few years, as the need to meet capital requirements and efficiency problems force them to merge. The process started most importantly with the merger of K&H Bank, owned by Belgium's KBC, and ABN Amro – Magyar Bank. Through this merger Hungary's second largest banking group was created (with the name K&H Bank) with a combined market share of about 15 per cent. Secondly, the Hungarian subsidiaries of Bank Austria-Creditanstalt and Germany's Hypo Vereinsbank in July 2000 announced their intention to merge their operations, following the merger of their parent banks. The merger in Hungary will create a bank with a balance sheet of about US\$ 1.63 billion. Finally, Citibank (US) announced its takeover of the retail branches of ING Bank (Netherlands) located in Hungary in summer 2000. Experts are predicting that the trend of market concentration will intensify in the near future.

A major question for the Hungarian banking system is the future of Postabank, the only large bank still in state hands. The authorities rescued Postabank in 1998 with a cash injection of US\$ 492.4 million and have since sought to restructure the company. In the latest development, the government announced that instead of selling the bank to foreign investors, they intend to find a partner, preferably a strong domestic bank, for Postabank. In November 2000, APV, the State Privatisation Agency, started talks with OTP about a possible partnership or merger between the two banks.

Non-bank financial institutions

Insurance

In September 2000, there were 22 insurance companies and 38 insurance associations. (Most of these associations cover agricultural risks.) The market is dominated by subsidiaries of the large foreign insurance companies that account for around 90 per cent of annual premiums.

In June 2000, the Hungarian Parliament accepted amendments to the 1995 Act on insurance institutions and insurance activity. This was the first step in the EU legal approximation process, and full compliance will be achieved by the date of accession. The main changes include a rise in the minimum capital requirements of insurance associations, increased transparency of ownership structures, liberalisation of the investment rules and strengthened prudential supervision.

Largest insurance companies in Hungary as at December 2000

Name	Strategic investor	Market share %
Hungaria	Allianz (Germany)	29.4
Generali-Providencia	Generali AG (Italy)	16.8
AB-Aegon	Aegon (Holland)	16.3
Nationale-Nederlanden	Nationale-Nederlanden (Netherlands)	14.4

Source: ERBD

Pension funds

Since January 1998, Hungary has been operating a three-pillar pensions system (Pillar I – the pay-as-you-go state system; Pillar II – contributions to private funds; Pillar III – voluntary mutual pension funds), which has provided the opportunity for the establishment and growth of private pension funds. Private pension funds have attracted 2.09 million members (50 per cent of the active population) since their start-up, and the value of assets managed by them reached HUF 114 billion (US\$ 4.5 billion) by the end of 2000. It is predicted that their impressive growth will continue and by 2010 their assets could equal 20.1 per cent of the country's GDP and their total members could reach 2.8 million.

The market is dominated by five large pension funds (OTP, Nationale Nederlanden, AB-Aegon, Hungaria/Allianz, Winterthur/Pannonia) that are responsible for around 82 per cent of all the private pension fund members in Hungary. In view of further legislative changes the five largest funds set up a framework for co-operation by establishing the Stabilitas

Pension Fund Alliance in autumn 2000. Members of the alliance will co-operate in further developing the legal and technical framework for the private pension fund system and will jointly represent the interests of its members.

The stock exchange

The Budapest Stock Exchange (BSE), although relatively small by international standards, is one of the most liquid in the region and very attractive to foreign investors. The existing supervisory capacity of the BSE is well established, meets the requirements of OECD membership and is largely harmonised with EU standards. The official BSE index is the BUX. The four major shares with the highest liquidity are MATAV (telecom), MOL (oil and gas), OTP Bank and Richter Gedeon (pharmaceuticals). In 2000, the BSE introduced fully automated futures and options trading.

In 2000, the BSE showed rather mixed performance. The BUX started at 8500 and then peaked at 10500 in spring. Following this, it started a downward trend and closed the year at 8000. Various external and internal shocks contributed to the fall of the BUX, with the negative sentiment on telecommunication stocks in Europe and the Hungarian government's attempts to limit gas and drug price hikes leading the list of the negative factors.

Throughout 2000, Hungarian domestic institutions (investment and pension funds) and households significantly increased their portfolios at the BSE, while those of foreign investors were slightly reduced. For the future, private pension funds, in operation since 1997, are expected to make a major contribution to growth and liquidity at the BSE through their increasing investments.

The debt market is dominated by government debt securities, while corporate issuance remains rather limited. Non-resident investors may purchase government bills or bonds with a maturity at issue of one year or greater.

Venture capital

Hungary has attracted the most venture capital in central and eastern Europe, and the majority of international funds operating there are regional. The country experienced a large influx in the mid-1990s as international investor confidence in the region strengthened. In the wake of the Russian financial crisis of August 1998, investors evacuated large parts of their portfolio, but 2000 has marked their return. According to *Oxford Analytica*, the main sources of capital are as follows:

- US institutional or private investors (60-70 per cent);
- European institutional investors or banks, including the EBRD (10-15 per cent);
- Hungarian banks (Magyar Fejlesztési Bank (MFB), MKB, K&H, and Postabank), private investors and the government.

Regarding investment patterns, the main investment targets are enterprises that fall into the upper medium-sized or large business categories in the context of Hungary's economy. Investment deals under HUF 100 million (US\$ 330,000) such as would be required by the majority of Hungarian SMEs are very rarely available, and many small-sized companies often fail to secure any financing. Therefore, due to its size orientation, foreign venture capital has not yet been able to ease the financial difficulties of the SME sector to any great extent.

The legislation on venture capital entities establishes strict requirements on establishing, licensing, reporting and conducting their activities and also grants certain tax benefits for Hungarian registered capital entities, which are not available to outsiders. However, due to the strict conditions, so far only one venture capital company has been registered, which is eligible for these tax benefits.



EBRD activities in Hungary

The European Bank for Reconstruction and Development (EBRD) has concentrated its activities largely in the Hungarian private sector. As at 31 December 2000, the Bank had signed 55 projects in Hungary for a total of € 1.1 billion, with a total value of € 4.5 billion. A total of 49 operations (€ 938.2 million) were in the private sector and six in the public sector (€ 196.0 million).

Overview of EBRD activities and key objectives

The EBRD's operational objectives in Hungary are detailed below.

Focus on private sector

Over 90 per cent of the EBRD's commitments in Hungary have been targeted at private enterprises or the privatisation of state-owned companies. The EBRD continues to focus on private local companies, including small and medium-sized enterprises (SMEs), in need of long-term financing (equity and debt) that is not available from commercial sources. Within this group, the Bank concentrates on companies which:

- do not have an international strategic partner;
- are engaged in restructuring or emerging from privatisation;
- are expanding across borders within the region; or
- need equity finance ahead of a possible stock market listing.

The EBRD also seeks opportunities to support the privatisation of utility and service organisations that are still state or municipally controlled.

Financing for infrastructure development

The EBRD will continue to focus on infrastructure projects that are critical for the overall development of the economy. Using its accumulated expertise in the country and the sector, the Bank will provide carefully structured financing for these types of projects, either on a private sector or private-public partnership or sovereign basis. Sectors such as municipal services, utilities, telecommunications, transport and environmental projects will be targeted. The Bank will undertake sovereign lending for projects, where private sector solutions are premature (for example, railways and certain other transport projects). Using its restructuring expertise, it will seek to add value to the process.

Enhancing the financial sector

To meet the developing needs of the corporate and household sectors, the EBRD will seek opportunities to provide long-term

funding to both large banks and specialised institutions and to participate in the privatisation of remaining state-owned banks. The Bank will also seek to support Hungarian banks in their efforts to better serve SMEs.

Enhancing the capital markets

The EBRD plans to facilitate access to the various capital markets and instruments needed by its clients. It will continue to develop and make use of a wide variety of traditional approaches as well as promote the development of innovative instruments.

The EBRD will be active on the public, private, domestic and international markets. It will offer its clients hedging instruments and other non-traditional products to complement commercial capabilities and its own lending operations. The further development of local currency funding options will also be emphasised.

Portfolio management

The EBRD will actively manage its investments to maintain a sound portfolio, generate appropriate returns for the risks taken and set a positive example by promoting sound corporate governance. This includes exiting from mature investments.

The EBRD cooperates with all the major international financial institutions that are active in Hungary. Coordinated activities with the World Bank, the International Finance Corporation and the European Investment Bank have generated a number of successful projects in both telecommunications and transportation. The EBRD also cooperates with the EC Phare programme in various areas, including financing SMEs, railway restructuring, and an environmental and energy efficiency credit line.

The Budapest Office has lead responsibility for operations in Hungary, including development, execution and monitoring of transactions. It operates with two expatriate and two local bankers.

Signed projects, as at 31 December 2000 (€ million), exchange rate as at 31 December 2000

Sector	No of operations	Total cost	EBRD debt	EBRD equity	EBRD total
Financial institutions					
Depository credit (banks)	14	576.6	205.3	113.5	318.8
Equity funds	3	96.3	0	24.2	24.2
Insurance, pension, mutual funds	2	35.8	0	14.1	14.1
General industry					
Automotive	2	171.6	30.7	9.6	40.3
Chemicals	3	81.9	10.2	14.8	25.0
Paper	4	45.3	10.9	4.2	15.1
Pharmaceuticals	1	75.9	0	37.8	37.8
Plastics and rubber	1	11.0	0	2.4	2.4
Primary metals	1	23.5	10.2	0	10.2
Printing and related support	1	10.6	4.1	2.0	6.1
Industry and commerce					
Accommodation	2	66.4	0.9	6.2	7.1
Telecommunications	7	1,958.0	121.1	57.3	178.4
Food manufacturing	1	4.1	4.1	0	4.1
Food services and drinking	2	27.4	0	3.0	3.0
Oil and gas extraction	1	91.3	26.9	0	26.9
Real estate	1	18.4	4.8	1.0	5.8
Wholesale trade	1	25.5	4.9	0	4.9
Infrastructure					
Energy efficiency	3	52.4	14.4	13.3	27.7
Transportation	7	1,015.6	357.2	4.0	361.2
Water and sewage	1	76.7	24.9	0	24.9
Signed projects total	55	4,464.3	830.6	307.4	1,138.0

Contact names

Alain Pilloux
 Business Group Director for Central Europe
 EBRD
 One Exchange Square
 London EC2A 2JN
 United Kingdom
 Tel: 44 20 7338 6521
 Fax: 44 20 7338 7199

Hans Peter Achermann

Country Director

Hubert Warsmann

Senior Banker (Equity Central Europe)
 EBRD Resident Office
 Rakoczi ut 42
 1072 Budapest
 Hungary
 Tel: 36 1 266 6000
 Fax: 36 1 266 6003

Notes